

Incentive programs: Some best practices

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Economic development incentives have been a popular tool for attracting, retaining and growing businesses for states and local governments for many decades. The state of Missouri provides millions of dollars in incentives annually. It is possible to point to projects that have been successful and provided a payback to the state or local economy. It is also possible to point to projects that did not live up to expectations and promises made. The research literature on economic development incentives finds their effectiveness still in doubt. Research is hampered by a lack of reporting requirements and a repository for information on incentives offered and consequences (Gabe and Kraybill, 2002). In addition, Deller (1998) notes that successful projects are more likely to be reported in the literature than those that fail. Without appropriate guidelines, performance contracts and reporting it is impossible for the state to know if the incentives are effective uses of public revenues. There are several aspects of incentive program that lead one to be concerned about their ability of generate strong returns to public investments.

First, firms receiving incentive benefits can be divided into two groups: 1) those that would have implemented the project anyway but applied for the incentive because it was available, and 2) those that would not have implemented their project without the incentive. Obviously, providing incentives to firms in the first category provides no payback on the public funds. It is difficult to know with certainty in which category a particular applicant firm falls. Peters and Fisher (2004) calculate that only about one in ten new jobs attributed to incentives is due to the incentives. However, with carefully designed eligibility criteria and thorough screening it may be possible to limit incentives to applicants in the second category but it must be conceded that some funds will go firms that do not need them.

The second reason for skepticism about economic development incentive programs is that the expectations and promises made prior to investment are not always fulfilled. In some cases the lack of complete success of ventures is because economic conditions change and firms must adjust. There is evidence that firms are simply too optimistic in their projections of growth. Gabe and Kraybill (2002) compared announced hiring intentions with actual hires two years after expansions by Ohio businesses. The firms which received incentives on average announced intentions to hire 91 workers but hired only 51. Firms that did not receive incentives on average announced plans to hire 45 workers and hired 45. Using statistical analysis they find that firms that received incentives created 10 fewer jobs than they would have without the incentive. Firms that did not receive incentives would have created 6 more jobs if they had received incentives.

Third, there is evidence that many firms that receive incentives are weaker firms. If the firm needs the incentives it may be an indication that the project is only marginally financially feasible (Gabe and Kraybill, 2002).

Fourth, firms that can be induced by incentives to locate in a particular location may be subsequently induced to relocate to another location. If firms do leave the incentives provided have been at least partially ineffective.

Finally, it is likely that firms induced to locate in the state will displace some amount of economic activity elsewhere in the state. Displacement may occur either because their production reduces the demand for the output of other firms in the state, or because they employ labor and other resources that are no longer available to other firms in the state. While some displacement is inevitable and sometimes desirable if the new economic activity and jobs bring more benefits to the state than the displaced economic activity and jobs, it is likely that the estimates of net economic benefits of the incentives are usually overstated. In

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addition there is the inappropriateness of creating an advantage for new businesses using tax paid by existing businesses that are frequently disadvantaged by the competition.

Given these empirical findings and uncertainties about economic development incentives there are several best practices which will increase the rate of return on incentive programs:

- 1) Incentive programs should not be entitlements. Firms that qualify for economic development incentive program without proving that they would not have invested in the expansion or location without the incentive, will rarely result in net benefits to the state or local economy.
- 2) Due diligence should be practiced in screening applicants for incentive funding including reviewing previous the performance if they have received incentives from other jurisdictions. This may include an independent economic and fiscal impact analysis of each proposed project.
 - 2.1) The economic impacts of a proposed investment include the net new jobs, wages and salaries and/or contribution to state domestic product or value-added. This calculation when compared to the full costs of the program is the basis of an accurate benefit-cost analysis of a proposed investment.
 - 2.2) Fiscal impacts of a proposed investment include the incentives given, the new tax revenues that will result from the economic impacts of the firm and the new demands on public spending as a result of the economic impacts. There seems to be an expectation that the applicant will increase tax revenues sufficiently to pay back the incentive which it received, an unrealistic expectation in most cases analysis (Peters and Fisher, 2004). Comparing incentives given to public revenues received is not an appropriate basis for benefit-cost analysis (see point 4). But a fiscal impact analysis will show whether the increase in tax revenues as a result of the incentives does or does not pay for the increased demands on public services.
- 3) The state should not make loans or grants to firms without a contract for performance. These contracts are referred to as 'claw back' provisions. These are often written in terms that tie the incentive payments to performance and longevity expectations. This practice would mean that successful applicants for incentive programs must meet the performance level for some time in order to qualify for funding. This type of stipulation prevents firms from making a temporary increase in employment or production in order to qualify for funding and then cutting back once the funds have been received.
 - 3.1) In order to be effective, contracts of this nature require that successful applicants must also be required to make periodic reports on their investments and hiring, and to provide access for the state or local jurisdiction to verify their reports.
 - 3.2) If successful applicants are not required to report their investment, employment and other indicators of success, the state or local government has very little basis on which to evaluate effectiveness of its programs or to decide which of its programs are most effective and perhaps merit expansion. Unfortunately, while many agencies are expected to report on the effectiveness of the programs, incentive recipients are often not required to report to the agency.
- 4) Guidelines should be established both for awarding incentives and for evaluating the programs. Guidelines should include the objectives of the program, the qualification criteria for the program, the reporting requirement under the program, and the process to be followed when calculating the benefits and costs of the program.
 - 4.1) In calculating benefits and costs all program costs should be included in the calculation—program administration, costs borne by other public and private stakeholders, and displacement effects.

4.2) In general the agency in charge of the incentive program should not evaluate the effectiveness of the programs it administers.

Conclusions

Giving incentives is like standing up at a football game. If one person stands to see better, it blocks the view of several behind, so they stand and this causing additional standing. In the end everyone is standing and no one's view of the game is improved. But if the majority is standing, then anyone who remains sitting will have their view completely blocked. As long as the majority of states are competing by giving incentives, then other states will likely be left out if they do not. Given this situation, careful implementation and evaluation of tax incentive programs will allow the best use of public money.

References

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